1958

First National City Bank Monthly Letter
Business and Economic Conditions

New York, February, 1958

General Business Conditions

THE post-Christmas letdown in production and trade has been greater than usual this year. The downturn which started last fall has carried further in January, and recent business reports feature rising unemployment, production cuts, slackness in new orders, and reduced fourth quarter profits. On the favorable side, little new has appeared, other than increased defense orders, although a good many lines such as construction and the general merchandise trades are holding well against the recessionary influences.

It would not be surprising if business and investment sentiment were poor, but on the whole that does not seem to be the case. Accepting the facts as they are, business men for the most part express no great pessimism. There is little expectation that the recession will turn into severe depression, and little weakening of faith in the resumption of growth in due course.

Business news seems unlikely to turn better in the early future, but it would be a mistake to put the whole blame on economic recession. Business is usually in the doldrums between Christmas and the start of the spring season. Unemployment ordinarily increases nearly one fourth between December and February because of post-holiday layoffs, inventory taking, and other seasonal factors. Retail sales drop somewhat more than one fourth in the same period. Construction, agriculture, and other activities dependent on the weather are at a low ebb. When such seasonal forces combine with the effects of a business adjustment, the resulting trends necessarily over-emphasize the extent of the decline.

Even with these qualifications, the drop in some lines has been substantial. Steel mill output for January is down 10 per cent from December and is averaging about 56 per cent of capacity. Passenger car production in January has run about 8 per cent less than in December and 24 per cent below a year ago. The Federal Reserve index of industrial production seems due for another cut in January after dropping to 136 in December, 7 per cent below the peak a year earlier.

Confronted with these signs of recession, Federal Reserve authorities in January reduced margins on stock market credit, cut the discount rate again, and permitted a moderate seasonal easing in member bank reserve positions. The Administration acted to stimulate home-building, placed an increased volume of defense orders, and asserted its willingness to "needle" the economy through deficit spending if necessary. Moreover, the budget and legislative program set forth the official view that the downtrend is likely to end soon and will be followed by a recovery in the second half.

An Inventory Adjustment

The impact of the business decline was revealed by statistics given in the President's Economic Report. The value of all goods and

CONTENTS

services produced dropped from the record annual rate of $439 billion in the third quarter of 1957 to $433 billion in the fourth. This was the first downturn in the gross national product in four years. Three points brought out by the figures are particularly pertinent: (1) the decline at this stage is to a great extent an inventory adjustment; (2) contrary to what many had expected, capital expenditures had not turned down in the fourth quarter of 1957, nor had defense expenditures stopped declining; and (3) consumer spending, widely counted on to bolster over-all demand, declined during the quarter.

The shift in inventory demand accounted for five sixths of the $6.0 billion decline in gross national product from the third quarter to the fourth. Business men had been adding to stocks at the seasonally adjusted annual rate of $2 billion in the third quarter, but in the fourth quarter they worked off inventories at the rate of $3 billion per year. This turnaround cut business demand for goods by $5 billion and overshadowed all other changes. The shift was a dramatic one, and is unlikely to be so large in any subsequent quarter. While the paring down of stocks doubtless will continue, the steepest part of the descent seems past so far as the impact of inventory changes on current production is concerned.

As the rate of change in inventory demand slows down, part of the goods which are presently being supplied out of stocks will have to be supplied from current output. Thus, sometime in 1958 demand from current production may pick up even though business men have not started rebuilding their stocks; if the level of inventories were all that counted, chances would be good for early improvement.

Opposing Forces

The level of inventories, however, is not the whole story. Stocks are excessive or inadequate only in relation to sales, production, or orders. These in turn reflect the demand from consumers, business, and government, and when such demand falls inventories sooner or later follow suit. The catch in the argument that an easing of inventory pressures will help pull business out of its decline by midyear is that this implies a well sustained rate of over-all demand.

While the decline so far has been primarily an inventory adjustment, the emphasis is now about to shift to the opposing patterns of contraction of plant and equipment spending and a renewed and expanded defense effort. More than anything else, the timing and strength of these two forces will determine the course of business in 1958. In so doing they will also shape the pattern of inventory demand.

In the fourth quarter of 1957, business fixed investment – producers' durable equipment and private nonresidential construction – remained steady at the annual rate of $49.5 billion, the same as in the two preceding quarters. Purchases of machinery and equipment edged off slightly, but commercial, public utility, and other construction was still increasing in the fourth quarter. This high level of plant and equipment investment is being maintained on the momentum of past contracts, orders, and decisions. Evidence has piled up of an impending downturn in capital spending. Declining new orders and order backlogs at machine tool and other machinery manufacturers, reduced capital appropriations, and expressed intentions of business executives all point to a lower rate of plant and equipment spending in 1958. In many cases, postwar expansion programs have been virtually completed, capacity has grown to cover not only present but some future needs, and the squeeze on profits has narrowed a source of investment funds.

Last fall, McGraw-Hill surveyed leading business firms and found that they planned to cut their 1958 investments 7 per cent from the record 1957 level. In view of later cutbacks, that figure is probably now on the low side. A 10 per cent decline, for example, would still maintain plant and equipment spending at a very high level, providing plenty of modernization, replacement, and new product capacity. But for the outlook the important point is that a 10 per cent cut would reduce the total by about $5 billion, not to mention the secondary effects on inventories and employment in capital goods plants and their suppliers.

Just as the rise in plant and equipment spending continued longer than many observers expected, a decline, once under way, is likely to persist beyond the first signs of a business upturn. McGraw-Hill economists now expect the decline to continue in 1959. In the previous downturn, the low point in gross national product was reached in the final quarter of 1953; the bottom in plant and equipment expenditures did not occur until the first quarter of 1955 – roughly 15 months later.

Defense Orders on the Upgrade

The revised defense program appears to provide the best hope of a dynamic offset to the shrinking demand for capital goods and inventories. The President's budget makes it clear that a relatively small increase in over-all de-

fense expenditures is scheduled for next year, but that a considerable step-up in defense ordering can be expected, particularly in major procurement and production. This category includes planes, missiles, ships, tanks, ammunition, electronics, and other major items, accounts for about a third of the defense budget, and probably has more direct impact on industrial activity than any other budget category.

New obligations for major procurement and production (roughly though not precisely equivalent to orders or contracts) had dropped to an annual rate of about $8.6 billion in the third quarter of 1957 from a peak rate of $21.5 billion in the second quarter of 1956. Estimates released at the time the budget was presented indicate a steady rise in new obligations with the second quarter of calendar 1958 perhaps matching the peak two years earlier. Obligations in fiscal 1959 are scheduled to be approximately as great as those in fiscal 1958, but Congressional action or the President's newly requested power to shift funds from one part of the defense budget to another may alter this picture.

The effect of these new defense orders on the economy is at first likely to be largely psychological, cushioning the effects of cutbacks elsewhere. The employer who receives or expects a defense order may be less apt to cut inventories or lay off skilled workers. Later the impact spreads to hiring, ordering material and equipment, and placing subcontracts. All this can happen before defense expenditures start to rise.

The effects of defense awards are already showing up in the business statistics. In November, new orders received by the transportation equipment industry jumped more than a billion dollars or 50 per cent over October, largely because of defense contracts received by aircraft firms. This is only the beginning, however, for an industry which has seen its backlogs cut 25 per cent—over $6 billion—in less than a year.

Reluctant Consumers

Consumer buying has been steady but not spectacular. The drop of $2 billion, or about 1 per cent, in consumer demand for goods in the fourth quarter points up the responsiveness of buying to changes in income, which also declined $2 billion in that period. A recent University of Michigan survey noted that, with unemployment, shorter hours, and higher prices, more consumers are concerned about the general outlook and their own financial situation. The proportion of families who think this is a bad time to make major purchases has increased markedly and the number thinking this a good time to buy declined correspondingly.

Against this background, it remains to be proved that consumers in 1958 will play the independent, dynamic role that they did in 1954 in speeding the recovery. Without the stimulus of a tax cut as in 1948 and 1954, it seems more likely that consumer spending — while holding at a high level — will play a more neutral role in this cycle.

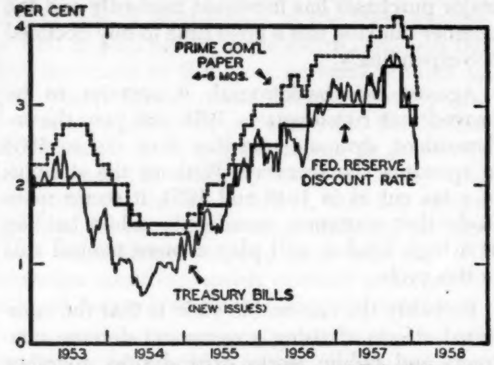
Probably the reasonable view is that the combined effects of rising government defense contracts and public works expenditures, together with a possible moderate recovery in homebuilding, well sustained consumer demand, and a check to inventory liquidation, can muster enough strength to prevent a long, spiraling decline. But it is less certain that they can provide the stimulus for strong recovery. The experience of 1954, when business bumped along the bottom for six to nine months before recovery got under way, is worth remembering.

Drop in Money Rates

On January 21 the Federal Reserve Bank of Philadelphia announced a ¼ per cent reduction in its discount rate to 2¾ per cent, starting a new sequence of discount rate cuts. The Federal Reserve Banks of San Francisco, Dallas and Minneapolis deferred action but all the other Reserve Banks had moved to the 2¾ per cent rate by the close of January. Earlier in the month, effective January 16, the Federal Reserve Board reduced margin requirements on listed stocks from 70 to 50 per cent. The amount of stock market credit outstanding fell off $455 million between June and December. Stock prices, of course, are generally far below their peak levels of 1956 and 1957. There did not seem to be any further justification for maintaining the higher requirements which had been applied early in 1955 to check increasing use of borrowed money to buy stocks.

The discount rate reduction, coming on top of the ½ per cent cut of mid-November, was interpreted as a further recognition of the weakening trend of business and as an adjustment to rapid declines in open market money rates to which the discount rate is normally related.

Yields on 91-day U.S. Treasury bills, which had averaged above 3½ per cent during September and October and 3⅛ per cent during December, slid off below 1¾ per cent at the month-end. Other classes of open market paper shared in the decline, although less spectacularly.



Short-term Open Market Money Rates and Federal Reserve Bank of New York Discount Rate, Weekly, 1953-58

Prime 4-6 months commercial paper, which had been offered by dealers to return 4⅛ per cent early last November, and which could still be bought to give a 3¾ per cent return during the second half of December, offered no better than 3⅛ per cent at the close of January. Rates on paper which leading sales finance companies sell in the open market directly to investors were marked down correspondingly. Yields on prime 90-day bankers acceptances, which touched 4 per cent briefly last August, and stood at 3⅜ per cent during the second half of December, were marked down to 2⅝ per cent during January.

Effects of Recession

Demand for open market paper normally improves with the passing of each year-end and the market was also affected by rumors of easing actions the Federal Reserve authorities were expected to take. But the unusual strength of demands that appeared this January reflected in very considerable measure the impact on the money market of business recession. Curtailments of inventory, production schedules, and capital spending programs strengthened cash positions of many business corporations and permitted them to take on larger amounts of open market paper as well as to reduce reliance on bank loans.

The demand for open market paper had its own influence in weakening bank loan volumes since large borrowers, such as the sales finance companies, took advantage of it to offer more open market paper and to use bank lines less actively. Corporate bond issues also provided resources for liquidating bank loans. Figures of the weekly reporting member banks for the three weeks ended January 22 showed a decline of $1.4 billion in business loans and $2.0 billion in total loans, a record which suggested that loan contraction for the full month might be greater than in any previous January. Leading banks cut their prime loan rates, from 4½ to 4 per cent, coincidentally with the further cut in Federal Reserve discount rates. Mortgage money was more readily available and even in surplus supply in some sections.

The reduction in bank loan rates was much more influenced by declining loan volume than by Federal Reserve operations. Many bankers expressed bewilderment at the interpretation of the further reduction of discount rate as an action designed to increase the supply of credit and thus to support business. The discount rate reductions, in themselves, do not provide any additional loan funds to the banks. The easier availability of bank loans so far has been attributable more to pay-offs than to additional cash reserves supplied by the monetary authorities. Nevertheless, the markets, and most particularly the bond market, lived in confident expectation that affirmative actions to release additional funds for lending would be taken.

Bond Financing

Bond prices extended their advances during January though in a more orderly and gradual manner than had been the case during the weeks immediately following the dramatic ½ per cent discount rate cut of mid-November. Yields on high grade state and municipal bonds, despite a large volume of new issues, declined further to about 2⅞ compared to 3 per cent at the close of December and a high above 3½ per cent last August and September. Underwriters offered new corporate bond issues of highest grade at an average rate of about 3⅝ per cent in January compared to 4 per cent in December and a high point of around 4¾ per cent last summer. Yields on U.S. government bonds slipped off further during the first half of January whereupon the market stabilized, somewhat below peak levels, awaiting disclosure of Treasury plans for refunding $16.8 billion Treasury maturities due between February 14 and April 15.

After the close of business January 29, Secretary of the Treasury Robert B. Anderson announced that holders of these securities would be offered, with appropriate accrued interest adjustments, a choice between one-year 2½ per cent certificates of indebtedness due February 14, 1959, six-year 3 per cent Treasury bonds due February 15, 1964, and 32-year 3½ per cent bonds due February 15, 1990. The new 3½s will be longer than any Treasury maturity save the $2.7 billion outstanding 3s due in 1995.

The Treasury has seized its opportunity, at a moment when other demands for long-term

credit are shrinking, to take a major step toward improving the maturity structure of the public debt and relieving the weight of early maturities which, in periods of tight money, have proved an embarrassment to the Treasury and an impediment to the enforcement of a restrictive Federal Reserve credit policy.

The Budget and Fiscal Policy

President Eisenhower's first post-Sputnik budget message, presented to Congress against a background of developing business recession, projects a close balance between revenues and expenditures for fiscal '59 beginning July 1. Nevertheless, the President found the $275 billion public debt limit "too restrictive in view of rising defense expenditures" and recommended a temporary increase. On January 23 the House of Representatives approved an increase to $280 billion until June 30, 1959.

The debt limit increase is most immediately needed because the current fiscal '58 budget, for the year ending June 30, has swung from a surplus to a deficit position. As the table below indicates, the expenditure estimate for fiscal '58 has been raised to $72.8 billion while the forecast of budget receipts, reflecting the impact of business recession, has been lowered to $72.4 billion. Thus, the $1.8 billion surplus which was initially projected for fiscal '58 a year ago has been replaced by the expectation of a $400 million deficit.

Federal Government Receipts, Expenditures and Public Debt

(In Billions of Dollars)

	Fiscal '57 Actual	Fiscal '58 Jan. '57 Est.	Fiscal '58 Oct. '57 Est.	Fiscal '58 Jan. '58 Est.	Fiscal '59 Jan. '58 Est.
Expenditures	$69.4	$71.8	$72.0	$72.8	$73.9
Receipts	71.0	73.6	73.5	72.4	74.4
Surplus (+) or Def. (—)	+1.6	+1.8	+1.5	—0.4	+0.5
Public Debt, June 30	270.5	269.2	269.0	271.2	271.2

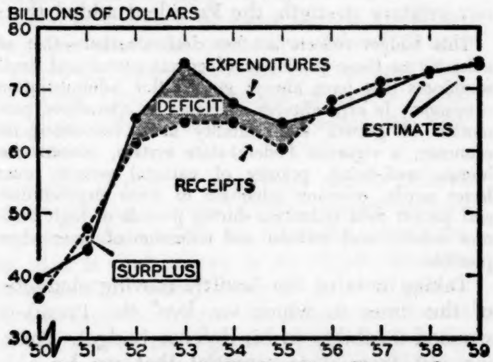
As the table shows, the President's budget for the new '59 fiscal year projects a $500 million surplus even though expenditures are expected to increase $1.1 billion further to $73.9 billion, pushed up by expansion in defense outlays. The explanation is that budget receipts are figured to rise even faster to a record $74.4 billion.

Against a background of business recession, many people expressed surprise at the forecast of increased receipts. The President took an optimistic view of the economic outlook, assuming that "expansion of our economy will soon be resumed, bringing higher levels of receipts with present tax rates." The Treasury is counting on personal income, which has been trending down since August, to rise to $352 billion in 1958 against $343 billion in 1957. Corporate profits in 1958 are figured to hold the $42 billion rate to which they slipped in 1957. While acknowledging that "there are many uncertainties in forecasting results eighteen months in advance" the President asserted:

> . . . The acceleration of defense efforts already underway, the increasing pace of activity in a number of programs involving state and local as well as Federal expenditures, the rapid pace of technological advance and its application by American industry, the expanding needs and desires of our growing population and Government policies designed to facilitate the resumption of growth are among the major factors that justify this confidence.

Even though the President may not be overoptimistic in his revenue forecast, a deficit is threatened by the rising tide of expenditure. His $73.9 billion spending estimate for fiscal '59 is likely to prove an underestimate if Congress adopts a spending mood, as not infrequently happens in election years. For another thing, the budget assumes that Congress will boost postal rates by $700 million to eliminate the bulk of the post office deficit.

The recent record shows spending estimates erring on the low side. Actual federal spending exceeded the initial estimate by $4.1 billion in fiscal '56 and $3.5 billion in fiscal '57. The $72.8 billion of expenditures now figured for fiscal '58 is already $1.0 billion higher than the $71.8 billion initial projection which aroused the ire of taxpayers a year ago.



U.S. Government Net Receipts, Expenditures, and Surplus or Deficit by Fiscal Years

The Sputnik Emergency

Reflecting the impact of the Russian sputniks on the nation's pride and sense of security, the fiscal '59 budget was developed in an atmosphere of urgency unprecedented for a peacetime year. The air was full of proposals for gigantic defense spending programs, even running into the tens of billions of dollars in the thought that money is no object where defense is concerned. They ranged from bomb shelters deep in the earth at

an estimated cost of $20 billion – though they could protect only part of the population – to nuclear-powered rocket ships with the price tag not filled in.

Less than a week before the budget was presented, Lyndon Johnson, Senate majority leader, released a statement asserting that a program to win "control of outer space" in order to gain "total control over earth" is so important that it makes budgetary consideration "irrelevant."

At the same time, proponents of big federal welfare programs are trying to hook every conceivable pet project onto the defense crisis while the spending fever runs high. Clarence Cannon, chairman of the House Appropriations Committee, summed up: "In and out of the Pentagon the country is in a mood of hysteria. A lot of people are ready to capitalize on it."

The President's Program

Against this background, President Eisenhower sought to maintain balance and perspective. While granting that the progress of the Soviets in long-range missiles and other offensive weapons compels us to increase our own defense activities, he pointed out that:

> Today we possess military superiority over any potential aggressor or aggressors. Every American should clearly understand that the vast defense programs undertaken during the past several years have greatly advanced our military preparedness and developed and harnessed impressive new scientific achievements.

After emphasizing determination to increase our military strength, the President added that:

> This budget reflects another determination – that of adhering to those principles of governmental and fiscal soundness that have always guided this Administration – economy in expenditures, efficiency in operations, promotion of growth and stability in a free-enterprise economy, a vigorous Federal-state system, concern for human well-being, priority of national security over lesser needs, revenues adequate to cover expenditures and permit debt reduction during periods of high business activity and revision and reduction of taxes when possible.

Taking note of the "swiftly moving character of the times in which we live" the President stressed flexibility in his defense budget. Pointing out that "it is essential that we be able promptly to modify and accelerate programs" to take advantage of "important discoveries or technological developments," he proposed a special $500 million reserve fund to exploit technological break-throughs and requested authority to transfer as needed up to $2 billion of appropriations among the military functions of the Department of Defense. Underlining the importance of flexibility, the President stated that more than 75 per cent of the total funds for procurement in the '59 defense budget are programmed for new types of equipment which had not been available as recently as fiscal '55. He added that while missiles took less than 2 cents of each dollar spent for major defense procurement in '53 they are scheduled to take 24 cents of each procurement dollar in '59.

To accelerate missile development and other defense programs, $3.4 billion more is proposed to be spent in '59 than was spent in '57. At the same time, the President revealed that the search for savings in the Defense Department is producing results – spending on aircraft and other conventional arms, equipment and installations is being cut $1.5 billion below '57 levels on the principle that keeping nonessential activities and installations in operation diverts "personnel and funds from our true defense requirements." A House Government Operations Committee report January 16 suggested that substantial further savings might result from a "complete review" of the foreign military aid program where political goals have led, at "tremendous financial loss," to the provision of "planes without anybody to fly them and vehicles without gasoline to run them."

On balance, as the President projects it, national security spending (including the special $500 million reserve fund to exploit technological break-throughs) is estimated at $46.3 billion in fiscal '59.

U.S. Government Expenditures by Major Programs
Fiscal Year 1959
(In Millions of Dollars)

	1959 Estimated	Amounts Above or Below 1958 Estimated	Amounts Above or Below 1957 Actual
National Security	$46,336*	+1,465	+1,922
Int'l. Affairs & Finance	1,312	— 156	+ 480
Veterans Benefits	5,012	— 22	+ 219
Labor & Welfare	3,643	+ 200	+ 677
Agriculture	4,601	— 323	+ 19
Natural Resources	1,492	+ 35	+ 196
Commerce & Housing	1,627	— 519	+ 174
General Government	1,403	+ 26	— 386
Interest	7,869	+ 2	+ 561
Reserve for Contingencies	639	+ 439	+ 639
Total	$73,934	+1,147	+4,501

* Including special $500 million reserve fund.

Nondefense Cutbacks

In a speech at Oklahoma City three months ago, shortly after the Soviets launched their second earth satellite, the President emphasized the need to put federal nondefense programs "through the wringer" in order to make room for increased defense outlays. He warned then that "this will be one of the hardest and most distasteful tasks that the coming session of Congress must face." Following this up, he recommends curtailments, revisions or eliminations of a host of the Government's "welfare" programs. These recommendations, he said, "provide the basis for budgetary savings of several billion dollars annually within a few years."

However, their impact on fiscal '59 spending is small, as the table above shows. Benefits to veterans and their families, which now comprise almost half the population, continue at $5 billion. Spending on Agriculture is set at $4.6 billion in '59, down $323 million from '58 but above '57 spending. Far-reaching proposals are offered to lower price supports, terminate the acreage reserve portion of the soil bank, reduce subsidies for conservation practices, and encourage private rather than government financing for rural electric cooperatives.

Spending on Labor and Welfare is figured to rise to a new high of $3.6 billion in '59, reflecting a new 4-year program of federal scholarships and appropriations for basic scientific research. To slow future expansion in this category, up 133 per cent since 1949, the President would reduce the Federal Government's share in the cost of State old-age assistance programs, hospital construction projects and schools affected by federal activities. Accepting the findings of a Joint Federal-State Action Committee, he recommended giving complete responsibility for programs of vocational education and the construction of waste treatment facilities to the States, increasing their financial capacity by releasing to them a portion of the federal local telephone service tax.

Promising further moves along these lines, the President said:

> . . . the continued vitality of our Federal form of government requires that, to the maximum extent possible, primary responsibility for public programs be shouldered by that level of government most familiar with local problems and most responsive to them. We must exercise the utmost restraint in assigning new programs and responsibilities to the Federal Government, and we should continuously search out those programs and activities now carried on at the national level that can and should be handled by the states or localities.

Other Civilian Programs

The sharp decrease in Commerce and Housing is based on the hope that Congress (which includes the postal service) will approve a $700 million postal rate boost. Without this, the '59 spending figure would be $181 million above '58 and no less than $874 million above '57, reflecting stepped up purchases of urban renewal and other special assistance mortgages by the Federal National Mortgage Association and federal aids for college dormitory construction and aviation. The President would shift more of the cost of slum clearance to local communities and States involved, raise interest charges on college housing loans to match rates paid by the Treasury, and eliminate FNMA's obligation to pay par for insured mortgages on housing for urban renewal or families displaced by government programs.

In Natural Resources – where the traditional pork-barrel of rivers and harbors spending is found – the President called for a complete stop on new starts of flood control, navigation, irrigation, water supply and power projects. Nevertheless, the mere continuation of projects started in earlier years is expected to push up spending in this category to a new high of $1.5 billion. The experience is a salutary reminder to the Congress of the short-sightedness involved in authorizing a host of starts on the basis of relatively low initial costs.

International Affairs and Finance is slated for $1.3 billion, down $156 million from '58 which included a large Export-Import Bank credit to the United Kingdom, but 58 per cent above actual expenditures under this heading in fiscal '57. Interest on the public debt is figured at $7.9 billion, about the same as in fiscal '58.

The Money Illusion

Despite the President's courage in facing up in principle to the need to make cuts in nondefense areas, the tightening up he proposes will not take effect soon enough to compensate for the rising course of defense expenditures. In fact, the total for what might be thought and construed as welfare – including outlays for Labor and Welfare, Commerce and Housing, Veterans' Benefits, Agriculture and Natural Resources – at a figure of $16.4 billion would be 16 per cent above the recent low of fiscal '55 and far above the figure proposed by President Truman in his fiscal 1950 budget proposals which were so roundly condemned as leading to a welfare state.

The fact is that far too many people believe that we can have more missiles, bigger welfare programs and an easier life all at the same time. The idea is that money is no object, that we simply need to spend freely in order to get all that we want. We forget that achievement is the product, not of big figures preceded by dollar signs, but of blood and sweat and tears. Nothing is more futile to real accomplishment, and demoralizing to organized productive effort than throwing more money helter-skelter in every direction. All we get out of irresponsible finance is price inflation and frustration of all our neatly-laid plans.

Thirty years ago, Irving Fisher of Yale coined an apt phrase, the "Money Illusion":

> . . . We simply take it for granted that "a dollar is a dollar" – that "a franc is a franc," that all money is

stable, just as centuries ago, before Copernicus, people took it for granted that this earth was stationary . . .

After our experience with the 50 per cent shrinkage in the buying power of the dollar since 1939 it is surprising that the "Money Illusion" persists among so many of the government planners and budget makers. Speaking January 6, Admiral Arleigh A. Burke, Chief of Naval Operations, suggested that we look at the budget situation this way:

The annual national expense account, the national budget, is something not far under eighty billion dollars. Money is the vehicle by which we translate ideas into action. This is power. This is more power than any of us had ever imagined a generation ago. The annual budget, this money, represents the national power.

Only in so far as inflation is avoided do bigger totals have tangible meaning. Germany's national budget in 1923, when the country was wracked by hyper- inflation, was astronomical; few nations were less powerful.

When we say that money is no object we also imply that we do not care how little it may buy in the markets or how much misery we may create among defenseless people who have put trust in the integrity of government.

The Budget and the Dollar

Historically, government has been the chief offender in inflation, whatever the means by which it sought to extort excessive amounts from the economy. In olden days, the sovereign clipped the coinage; the development of paper money brought the printing press to the fore as an instrument of inflationary government finance; the advent of central banks made Treasury deficit financing a tempting way out for the government with a small purse but big ideas. All of these methods are now discredited.

But we have yet to recognize that high and rising government expenditures can be inflationary even if expenditures are covered by taxes. As Arthur F. Burns, former Chairman of the President's Council of Economic Advisors, pointed out in *Prosperity Without Inflation*, published last December:

A balanced budget is often regarded as indicative that the fiscal operations of the federal government are neutral in their economic effects . . . This simple view, however, overlooks the fact that the impact of a huge sum of tax money spent by the government may be very different from the impact of an equivalent expenditure by consumers and business firms.

In the first place, government officials as a group are probably somewhat less efficient shoppers than private citizens. Second, the prices of much of what the government buys are reckoned on a cost-plus basis or something close to it. Third, government contracts are ordinarily subject to special provisions regarding wages and other labor standards. Fourth, the high income taxes that are imposed to finance high government expenditures occasionally lead businessmen to be improvident about the prices or wages that they pay.

Fifth, expenditures by the government, which nowadays are of necessity heavily concentrated on national defense, seem unlikely to contribute to the improvement of industrial capacity and productivity to the same degree as would private expenditures of the same magnitude. Sixth, when an increase in governmental expenditures is financed by an increase in taxes, the increase in public spending will not always be accompanied in the short run by an equivalent reduction in private spending, so that the nation's total spending may well be larger as a result of the expansion of a balanced budget.

Regular budget figures on federal spending understate federal demands on the economy. In addition to the $73.9 billion spending included in the budget, fiscal '59, there are heavy expenditures by federal trust funds outside the budget for such purposes as social security and highway construction. Total federal cash payments to the public are projected at no less than $86.7 billion in fiscal '59. Adding in an additional $50 billion for State and local government expenditures, government on all levels is planning to take about 31.5 per cent of the gross national product in fiscal '59, the highest ever in peacetime.

President Eisenhower has cited as one of his "hardest problems" the interaction of inflation and the budget. Last October he said:

. . . every single department of government, most of them pleading the responsibilities that have been placed upon them by law, want more money. They quote rising prices, higher prices, and, of course, we know bigger budgets contribute to still higher prices.

The record is at hand.

What To Do?

The excitement over the Soviet satellites has waned though they have left us reason not only to accelerate missile projects and bolster the quality of our educational system, but also to ponder the true sources of national strength in the energy of the self-reliant citizen.

The deterioration of business activity and optimism also gives cause for examination of appropriate remedies. Should those remedies be found in bigger federal expenditures on all fronts? This would seem to be the direction toward which the Congress is tempted. Or should they be found in stimulations from tax reforms? Either way risks appear that the budget will, for a time, be unbalanced. This can scarcely be avoided. Our tax system, relying for 80 per cent of federal revenues on income taxation, makes deficits inevitable when business slides off.

Between increasing expenditures and cutting taxes as a support to business, the choice of cut-

ting taxes is more likely to restore a balanced budget. We need to recognize the deterrent effect of taxes on taxpaying enterprise. We have the experience of the 1954 tax cuts, adopted at a time when the budget was unbalanced. The economy was immensely stimulated. Within two years the revenues were greater – at reduced rates – than they had ever been before. The erosion of the dollar was stopped. The resumed erosion of the dollar in 1956 and 1957 coincided with a renewed rise in government spending.

The budget has never been balanced by so-called pump-priming increases in federal expenditures. The most spectacular failure in our fiscal policy history was the effort during the great depression to produce prosperity and balanced budgets out of increased federal expenditures and taxes.

The most promising route back to prosperity and balanced budgets is to relieve the tax rates which are most constrictive of enterprise. This is the approach adopted in the forward-looking Sadlak-Herlong bill which, over a period of years, would re-scale income tax. If reforms succeed in encouraging taxpayers to develop more taxabie income the Government can get stimulation to activity and more revenues than otherwise. Excessive greed in tax-rate setting is no wiser for government than excessive greed in price-setting for industry.

If this is true, we can strengthen the base not only of revenues but also the base of national strength, of energy applied by the self-reliant taxpaying citizen. We can carry more readily and successfully the burdens of a costly defense establishment.

The degree to which the Federal Government can accelerate missile development is limited by considerations of available scientific manpower. Little help in stimulating business broadly can come from that source, at least over any brief period. The question is whether outlays on all sorts of programs should be accelerated to provide economic stimulus. On the record, this will not work to rebalance the budget or restore prosperity. What it will do is re-energize the wage-price spiral and undermine the structure of social security which rests on stable money.

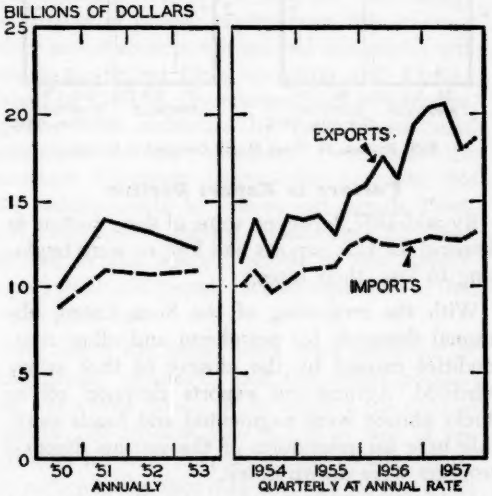
The House Ways and Means Committee, under the chairmanship of Congressman Wilbur D. Mills, is pursuing its studies of our warped and leaking structure of income taxation with a view to preparing recommendations for support to the economy through tax changes. The Congress will have a chance to choose between more public spending and inflation, on the one hand, and tax rate reforms to bolster the revenues, the integrity of the tax system, and the incentives for progress.

Foreign Trade Boom Subsiding

The boom in U.S. foreign trade, which in the first half of last year carried commercial exports (excluding military aid) to a record annual rate exceeding $20 billion, has been subsiding. During the second half of the year such exports dropped to an annual rate of slightly over $18 billion.

Last year's commercial exports mark, as shown by the following chart, the culmination of an upsurge beginning late in '54. At the total of around $19.4 billion now estimated for the full year, they were up 12 per cent from '56 and 51 per cent from the level of '54.

With imports at an estimated $12.9 billion, up 2.5 per cent over '56, the surplus of exports over imports swelled to $6.5 billion, the largest in ten years.



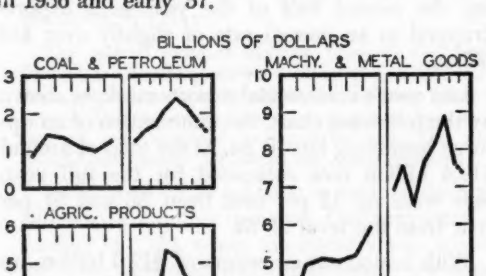
U.S. Exports-Imports, 1950-57

Several factors contributed to the export bulge last year. One was the temporary stimulus to demand for petroleum, coal, and various other commodities imparted by the blocking of the Suez Canal. Another was a strong but short-lived stimulus to agricultural exports provided by the bad harvest in Europe in 1956 and need for replenishing cotton stocks, coupled with the drive in this country to dispose of surplus farm commodities at bargain prices.

Along with these transient factors was the exuberant growth of the Free World economy, manifested in rising productivity, unprecedented investment activity, and the development of mass

markets for industrial goods. Inflationary pressures and full employment abroad, accompanied by rising consumption, stimulated purchases here of both raw materials and capital equipment.

The next chart shows the rapid build-up in exports of American machinery and metal goods since '54, along with the boost in exports of agricultural products and of coal and petroleum in 1956 and early '57.



U.S. Exports in Three Major Commodity Groups

Factors in Export Decline

By mid-1957, however, some of these factors in demand for U.S. exports had lost, or were beginning to lose, their force.

With the reopening of the Suez Canal, abnormal demands for petroleum and other commodities caused by the closing of that artery subsided. Agricultural exports dropped off as stocks abroad were augmented and funds available here for promotion of the surplus disposal program were drawn down.

At the same time the boom in the Free World economy, following its rapid expansion of recent years, began to level off. Prices of internationally traded commodities weakened, affecting the buying power of the producing countries.

But more basically, the fall in U.S. exports stems from the lopsided expansion in U.S. foreign trade noted above, reviving the old problem of the so-called dollar shortage. With foreign takings of our goods soaring far in excess of foreign sales to us, it was only a question of time before difficulties in payments would reappear.

Moreover, in addition to financing greater purchases of U.S. merchandise, more dollars were being used for other purposes. Shipping charges skyrocketed during the Suez crisis. Servicing U.S. private investments abroad of $33 billion book value and U.S. Government credits and claims of $16 billion called for $2.9 billion.

Also, Western Europeans and Canadians have been acquiring long-term assets in this country, for diversification and as a hedge against inflation and general insecurity in other parts of the world. Direct investments by foreigners in industrial enterprises here, plus purchases of American securities, were at an annual rate of over $600 million during the first half of '57 but dropped sharply in the last half.

The "Dollar Gap" Again

In consequence, the world outside the U.S. found itself in the last quarter of 1956, at the height of the Suez affair, spending more dollars than it was receiving in earnings or giveaways. The so-called dollar gap of the early postwar years was back.

From the start of the fourth quarter of '56 through the third quarter of '57, foreign countries, according to the Department of Commerce, ran behind some $900 million in their transactions with the U.S., necessitating corresponding drafts on their holdings of gold and dollars. Following are the figures by quarters:

Net Gains or Losses in Foreign Gold and Short-term Dollar Assets in Transactions with the U.S.

(In Millions of Dollars)

1956 4th quarter	$—302
1957 1st quarter	—522
1957 2nd quarter	+182
1957 3rd quarter	—260
Total 4 quarters	$—902

It will be seen that the loss in foreign reserves disappeared temporarily in the second quarter, mainly because of large payments to Venezuela for oil drilling rights. This special factor apart, the third quarter showed a reduced loss, and indications are that the fourth quarter produced some gains. In this conection, it may be noted that several major countries have made determined efforts to control inflation and bring their foreign transactions into balance. This, in conjunction with the recent slackening in U.S. exports, has lessened the demand for dollars.

It is noteworthy that this "dollar gap" reoccurred in the face of peak U.S. dollar disbursements abroad resulting from purchases of goods and services, loans, economic aid, and private investment. According to Commerce Department estimates, dollars made available from all sources to foreign countries during '57 approached $27.5 billion — more than 40 per cent over '54. This is

exclusive of disbursements by the International Monetary Fund which totaled $1 billion in 1957.

Huge as the over-all supply of dollars has been, it has nevertheless fallen short of requirements called for by the record foreign spending for American goods and services, flow of private capital to this country, and building up of private dollar balances. The shortage of foreign exchange in countries like France, India, Spain, and Colombia has not been confined to dollars alone but has included other currencies as well.

Despite these drains, over-all foreign official gold and dollar reserves have continued to grow – replenished by the heavy drafts on the International Monetary Fund (which must be repaid later) and by receipts of newly-mined gold and purchases of Russian gold offered in world markets. This is not to say that monetary reserves of all individual countries are adequate, for such of course is not the case.

Cyclical Adjustments World-Wide

Perhaps the most significant conclusion to be derived from this review of trade and capital movements is that the U.S. economy at this juncture is not likely to have the same degree of support from the outside world that it had during the two previous postwar recessions. Indeed, the President, in his Economic Report submitted to Congress last month, predicted that a decline in foreign demand "is likely to exert a moderately contractive influence on economic activity for the time being."

In 1948-49 and 1953-54, while the U.S. experienced a setback, the rest of the world forged ahead. In the earlier period, Western Europe, aided by the Marshall Plan, was still in the early stages of its reconstruction boom, the momentum of which carried steadily forward despite the currency crisis and round of currency devaluations in September '49. Similarly, in 1953-54, Western Europe and Canada, despite apprehensions, showed no parallel to the downturn that took place in the U.S. In both these periods the maintenance of foreign demand exerted a supporting influence on world prices of primary products, helped to sustain our exports, and cushioned the fall in business here.

Today the situation is different. Credit tightening moves by West European central banks, made earlier last year to contain inflationary excesses, have taken hold. Industrial production in most countries on the Continent, while still above year-earlier levels, has slowed its rate of advance. With surplus industrial capacity becoming more evident, the investment boom has topped off. Inflationary pressures have abated as shortages have disappeared and as demands for goods and services have become less urgent. In short, the edge is off the boom in most countries throughout the world.

This prospect of cyclical adjustments abroad coinciding with similar developments here is clearly a factor to be reckoned with.

At the same time, factors potentially sustaining to world trade and capital movements should be noted. Private capital flows may indeed be lower in view of capacity surpluses now appearing in many basic industries. On the other hand, investment in the development of such natural resources as petroleum takes into account conditions some years hence rather than just a year or two ahead. The potential benefits of the Common Market in Western Europe may also bolster the outflow of private capital from this country. Other major sources for wanted currencies will include continued large spending and lending abroad by the U.S. Government and its agencies, together with assistance by such international institutions as the Monetary Fund and the European Payments Union – for example, the $655 million credit to France last month. President Eisenhower's budget request for a $2 billion increase in the lending power of the Export-Import Bank will permit further expansion of that Bank's activities.

The world has never been more conscious of rising living standards, and the world population has never grown at so rapid a pace as at present. The trouble now is not in lack of opportunity for world expansion and development, but rather in the fact that everywhere the effort has been to do too much too fast. Plainly many countries face periods of adjustment, and will have to work out the problems that have accumulated during the past few years of unprecedented growth and prosperity. The strong dynamic urge for growth, manifest everywhere, should powerfully assist this process. Once necessary adjustments are made, technical progress, economic expansion, and international trade can again go forward.

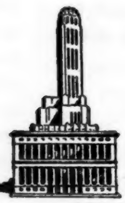
HIGHLIGHTS of 1957

from the Annual Report of

The First National City Bank of New York

and

City Bank Farmers Trust Company



In 1957:

▶Operating earnings, after taxes, totaled $60,-204,787 ($5.02 per share on 12,000,000 shares outstanding).

▶Operating earnings less losses on sales of securities totaled $58,914,396 ($4.91 per share).

▶Dividends paid totaled $30,500,000, equal to $2.90 per share. The current dividend rate is $3 per share per annum.

▶Total staff expense, domestic and foreign, came to $85,400,000.

▶Taxes, here and abroad, totaled $66,100,000.

▶Two million additional shares of capital stock were sold at $60 per share, a total of $120,-000,000.

▶Capital funds at the year-end total $735,764,393 ($61.31 per share) compared with $602,182,-963 ($60.22 per share) a year earlier.

▶Total resources of the Bank increased to $7,-637,000,000 and deposits to $6,693,000,000. These are all-time highs. Loans total $3,868,-000,000.

▶Six new branches were opened; three in New York and three overseas.

▶The Bank has at the year-end 78 domestic branches and 71 overseas branches, offices and affiliates.

▶Depositors' accounts number 1,200,000, staff 16,848 and shareholders 71,460.

For copy of complete Annual Report, write the Public Relations Department, The First National City Bank of New York, 55 Wall Street, New York 15, New York.

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